Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Chu | Analyst: LuAnna Hass | Bill Number: AB 585

Related Bills: See Legislative History | Telephone: 845-7478 | Introduced Date: February 18, 2003

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Tax Enforcement/Creation of Elite Tax Enforcement Unit

SUMMARY

This bill states the intent of the Legislature to create an Elite Tax Enforcement Unit to assist the Franchise Tax Board (FTB) with the collection of underreported taxes.

PURPOSE OF THE BILL

It appears the purpose of this bill is to increase compliance with the state's income tax laws.

EFFECTIVE/OPERATIVE DATE

This bill contains intent language that would be effective and operative January 1, 2004.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Under current federal and state income tax laws, numerous penalties may be imposed for the nonreporting or underreporting of income. Some penalties are imposed against either individual or corporate taxpayers, while others target corporations that are doing business and are out of compliance with the franchise and income tax laws. Additionally, certain penalties are imposed against third parties that assist taxpayers in the nonreporting or underreporting of their income. Further, certain fees are imposed against taxpayers that fail to file returns or pay their tax liabilities. Appendix A contains a general brief description of these penalties and fees at the state level.

Taxpayers that fail to report or underreport their income also may be subject to criminal sanctions. Depending upon the gravity of the offense, such taxpayers may be guilty of either a misdemeanor or felony violation. Upon conviction at the state level, such taxpayers are subject to fines and/or imprisonment, together with costs of investigation and prosecution. Typically, the district attorney acts as the prosecuting attorney.

Board Position:			Department Director	Date
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When taxpayers fail to file income tax returns, the statute of limitations never commences running so that FTB may have as long as necessary to ensure taxpayer compliance with the filing requirements. However, to encourage certain out-of-state taxpayers to comply with the filing requirements, current income tax law allows FTB and taxpayers to sign voluntary disclosure agreements. These agreements allow FTB to waive penalties for those taxpayers that: (1) voluntarily file all required returns, (2) pay all the tax, penalties, and interest with respect to the preceding six taxable years, and (3) agree to subsequently comply with all California's income tax laws.

If taxpayers do not report or underreport their income, FTB has the authority to estimate net income from any available information. Once the tax liability is determined based upon the estimate of net income, FTB may issue notices of proposed deficiency assessments (NPAs) for the additional tax, penalties and interest.

Since the 1980's, FTB has increased its activities that target the nonreporting and underreporting of tax liabilities. Appendix B provides details relating to these activities: enforcement, collection, and criminal investigation.

Information disclosed on returns, reports, or documents required to be filed with FTB, including the business affairs of a corporation, cannot be disclosed to other parties, unless the disclosure is expressly authorized by law. Under current law, FTB is expressly authorized to share this information with the following taxing authorities: Internal Revenue Service, Employment Development Department, and the State Board Of Equalization.

THIS BILL

This bill consists of legislative intent language that would state the following:

- Studies indicate $200 billion income tax dollars are not paid or reported to the Internal Revenue Service (IRS) on an annual basis.
- It is estimated that, at best, only 85% of tax dollars are actually reported and paid.
- Using the same ratio for California personal income and corporation taxes, it is estimated that $7.4 billion income tax dollars are not paid or reported to FTB.

In addition, this bill would state the intent of the Legislature to create the Elite Tax Enforcement Unit (ETEU) to assist FTB in the collection of underreported income and corporation taxes. The ETEU would be comprised of tax attorneys from the private sector. Those tax attorneys would be paid salaries equal to those paid to senior tax attorneys employed by the state.

IMPLEMENTATION CONSIDERATIONS

Since this bill consists of only legislative intent language, it does not impact the department's programs and operations. It is anticipated that the ETEU would need statutory authority to undertake the tasks outlined in this bill. Therefore, department staff has identified the following implementation considerations for purposes of a high level discussion; additional concerns may be identified as the bill is expanded beyond mere legislative intent and moves through the legislative process. In order for a program like ETEU to be implemented, clarification is needed for at least the following issues:

- A clear definition of the ETEU and its members. The bill specifies that the ETEU would be comprised of tax attorneys from the private sector. However, it is not clear by the intent language whether the ETEU would be a part of FTB, a separate government entity, or a private entity. Would the ETEU contain members other than private sector tax attorneys? If so, those members would need to be included in the bill.
- Clarity regarding the specific function of the ETEU members. Specifically, this bill states that the ETEU would "assist FTB in the collection" of underreported personal and corporation taxes. Does the author envision the ETEU operating in a consulting function with FTB, issuing assessments for unreported income, or assisting FTB in the actual collection of unpaid taxes from the taxpayers?
- Clarification of the salaries of the private sector attorneys. This bill states that the private sector attorneys would be paid salaries equivalent to those paid to senior tax attorneys employed with the state. However, it is unclear who would be responsible for paying the salaries. As mentioned above, if the ETEU would become part of FTB or another government entity, the appropriate agency would need an appropriation to fund the salaries.
- The disclosure of taxpayer information. As stated under "Federal/State Law" above, state tax law provides that taxpayer information is confidential and FTB may disclose the information in only limited circumstances and only to specific agencies as authorized by law. This bill states the ETEU would be comprised of private sector attorneys. Unless this bill were amended to expand the current disclosure laws to include the ETEU and allow it access to taxpayer information, FTB would be unable to share any taxpayer information or information received from other agencies.

PROGRAM BACKGROUND

Under current department practice, the department collects personal information from various sources, including from the taxpayer and from agencies required to report financial information. This information is used for compliance development, audit, and collection purposes. As required by statute, all information received from the taxpayer is confidential and is shared with federal or state agencies only for statutorily specified purposes.

OTHER STATES' INFORMATION

Since this bill contains only legislative intent regarding a new tax enforcement unit, a review of other states' tax information would not be relevant at this time.

FISCAL IMPACT

As written, this bill does not impact the department's costs.

ECONOMIC IMPACT

As an intent bill, this bill would not impact state income tax revenue.

LEGISLATIVE STAFF CONTACT

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Appendix A

Commonly Imposed Penalties

The following are the more commonly imposed penalties under current income tax laws against taxpayers that do not report or underreport their income, or do not pay deficiency assessments:

- Late filing – income tax returns that are filed late are subject to two types of late filing penalties: (1) a basic penalty of 5% of the tax per month that the return is late, up to a maximum of 25% of the tax, or (2) a minimum penalty of the lesser of $100 or 100% of the tax liability, if the return is filed 60 days or more late and the basic penalty is less than $100. If the failure to file is due to fraud, the basic penalty is 1% per month, up to a maximum of 75%.
- Underpayment – income taxes that are not paid by the original due date of the income tax return are subject to a penalty of 5% of the unpaid tax PLUS 1/2 of 1% per month, up to a maximum of 40 months (20%).
- Demand – income tax returns that are not filed upon notice and demand from the FTB are subject to a penalty of 25% of the amount of the tax required to be shown on the return.
- Frivolous return – income tax returns that are not sufficiently completed to substantially determine the correct self-assessed tax are subject to a penalty of $500.
- Accuracy-related – substantial understating income tax, overstating values of items, or overstating pension liabilities are subject to a penalty of 20% of the additional tax that is accuracy related. If the misstatements are due to fraud, the penalty is 75% of that resulting tax.

Corporate Penalties Relating To Doing Business

Corporations that are doing business while out of compliance with the tax laws are subject to the following penalties that may be significant:

- If a corporation’s rights, powers, and privileges are suspended or forfeited for failure to file an income tax return or pay the tax, the corporation’s contracts are voidable. To be relieved of voidability, the corporation must be brought to full compliance with the tax laws. In addition, the corporation must pay a penalty of $100 for each day that voidability relief is being sought (not to exceed the tax amount).
- Certain corporations that are doing business in California and have not filed income tax returns are subject to a $2,000 penalty per tax year.

Third-party Penalties

Third parties that assist taxpayers in their failure to comply with the income tax laws may be subject to the following penalties:

- tax preparers who understate a taxpayer’s tax liability on any return are subject to a $250 penalty, which increases to $1,000 if the understatement is a result of willful or reckless conduct.
- persons who aid and abet a taxpayer in understating the taxpayer's tax liability are generally subject to a penalty of $1,000 per taxpayer for each year.

Appendix B

Enforcement Activities

In 2001, FTB began its filing enforcement process for individual taxpayers under its newly developed Intergrated Nonfiler Compliance (INC) system. In 2002, INC was expanded to include corporate taxpayers. Under INC, the computer sorts through more than 220 million records received from employers, banks, the Internal Revenue Service (IRS), and other sources, and matches them against tax returns filed. Those taxpayers with California income for whom FTB has no record of an income tax return being filed, and are repeat nonfilers, a demand letter is sent requesting that the past due return be filed. Repeat nonfilers that do not file as requested are subject to the demand penalty. The other taxpayers receive a reminder letter instead of a demand letter and, hence, are not subject to the demand penalty.

If a return is not filed as required, the taxpayer's net income is estimated from the available information, and a deficiency assessment is proposed. For taxpayer assistance, a special Internet website has been created. Under this web site, taxpayers identified through INC can request more time to file their income tax returns, retrieve information that can assist them in the filing of the income tax return, learn about payment options, and correct misreported information. The filing enforcement process generally begins after the extended due date of the tax return and with issuance of the demand or reminder letter. During 2001, more than 200,000 NPA's were issued for income tax returns that were not filed for tax year 1999. It is anticipated that when INC for individual taxpayers is fully operational the proposed assessments will be issued within 12 months from the beginning of the process. Once fully operational, within the next few years, staff anticipates INC NPAs will total 400,000 per year.

In addition to this automated filing program, FTB has a large audit staff designed to encourage compliance with the income tax laws. For this purpose, typically, computer programs search state and federal income records to detect leads as to discrepancies between income items that were reported and should have been reported on income tax returns. Based on the computerized search of these records, one of many audit-type activities may be initiated, ranging from clerical inquiries, computer-generated inquiries, manual desk audits or field audits, to a combination of computer and manual audits. FTB typically seeks funding for audit-type activities for all cases with a cost-to-benefit ratio (CBR) of 1:5 or greater, based on the net proposed tax assessments. Audits with a lesser CBR may be conducted on a case-by-case basis.

Collection Activities

Once assessments are final, taxpayers are notified and payment is requested. Taxpayers having a financial hardship and unable to pay their taxes in full may be eligible to enter into installment payment agreements. For taxpayers who do not have, and will not have in the foreseeable future, the income, assets or means to pay their tax liability, the taxpayer may consider offering a lesser amount for payment of the tax liability. If taxpayers disregard FTB's notice for payment, FTB will send taxpayers notice preliminary to the taking of collection action. There is no statute of limitations on collections.

If an account is unpaid after sending the collection notice, FTB uses an automated computer system to continually search asset records. Typically, a notice of state tax lien is recorded as the first action taken. Then, depending upon the type of asset identified, the appropriate collection remedy is initiated, which may include garnishing wages, attaching bank accounts, or taking other collection actions.

Recently enacted legislation allows FTB to identify eligible taxpayers with high-risk collection accounts and offer those taxpayers the opportunity to satisfy an unpaid tax liability by paying the tax in full and receiving a waiver of interest, penalties, and fees. This program is operative for the period from October 1, 2002, through June 30, 2003.

<u>Criminal Investigation Activities</u>

FTB investigators work leads from various information sources to identify the amount of tax that should have been reported. FTB investigators were recently granted peace officer status, enabling them to issue search warrants and recover the cost of FTB's criminal investigation from the taxpayer. Currently investigators are working approximately 300 cases. This number is expected to increase consistent with the augmentation in staff (six positions for three years) to pursue additional leads and cases. In addition to the direct benefit to the state from the compliance achieved from the taxpayers that are prosecuted, these cases deter others in the trade or industry from violating the law. Taxpayers that are under criminal investigation are not immediately or readily notified of the on-going criminal investigation. The element of surprise is necessary in obtaining the needed records or information through a search warrant, subpoena, interviews, or other actions. It is only when these actions are taken that the taxpayer may be aware of pending criminal investigations. FTB's criminal investigation cases are turned over to the appropriate district attorney, who in turn files a complaint against the taxpayer. A criminal investigation case may take several years to complete from the time the lead is obtained until the time the complaint is filed.